

Internal Revenue Service
memorandum

CC:TL:TS
JIRosenberg

date: **15DEC 1989**

to: District Counsel, Louisville C:LOU
Attn: Jillena A. Warner, Special Litigation Assistant

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]

This memorandum is in response to your request for tax litigation advice dated June 13, 1989.

Issue

How is a deficiency to be computed for purposes of a Tax Court decision after Munro v. Commissioner, 92 T.C. 71 (1982)?

Conclusion

In computing a deficiency for purposes of a Tax Court decision when the deficiency case is settled prior to the completion of the TEFRA case, the TEFRA items are to be treated in the computation as if they were correctly reported on the return. The decision document should then stipulate that any change to the deficiency liability caused by resolution of the TEFRA proceeding can be assessed at the conclusion of the TEFRA proceeding as a computational adjustment. See Notice N(35)(24)60-1.

Under the facts of this case, however, the TEFRA items were settled prior to the completion of the deficiency case. Consequently, the TEFRA items should be included in the computation as they were finally determined. Thus, the decision document would reflect an overpayment of \$ [REDACTED] and the Tax Court would have jurisdiction to grant this overpayment pursuant to I.R.C. § 6512(b).

Facts

On [REDACTED], the petitioners were issued a statutory notice of deficiency covering the years [REDACTED] and [REDACTED]. For the year [REDACTED] the adjustments were primarily due to [REDACTED] (a non-TEFRA partnership) and investment interest expense carryover (also a non-TEFRA item). The notice determined a deficiency of \$ [REDACTED] for taxable year [REDACTED]. While the notice of deficiency adjusted only non-TEFRA items, the petitioners were involved in two TEFRA partnerships in [REDACTED] the

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██████████ and ██████████ partnerships. In accordance with the Service's position at the time, the TEFRA partnership items were assumed to be correct and were reflected in the taxable income used in computing the deficiency. The petitioners' ██████████ return included \$██████████ of income from the two TEFRA partnerships. The taxable income as shown on the petitioners' ██████████ return was \$██████████ and the adjustments to taxable income per the notice of deficiency totalled \$██████████ resulting in a deficiency of \$██████████.

The petitioners and the appeals officer have reached a basis of settlement for both ██████████ (involving the ██████████ and ██████████ years) and ██████████ (involving the year ██████████). The cases for ██████████ and ██████████ primarily involved adjustments to items flowing from ██████████ and ██████████ partnerships (which were non-TEFRA in ██████████ and ██████████). As part of the settlement for ██████████, wherein the petitioners agreed to the disallowance of losses from ██████████ and ██████████ partnerships, the appeals officer secured a closing agreement providing for the reversal of all income and deductions from those partnerships in subsequent years. The closing agreement has been executed by the petitioners but has not yet been executed on behalf of the Commissioner.

The appeals officer initially prepared settlement computations adjusting the non-TEFRA items in ██████████ and also reversing the TEFRA partnership items for ██████████ in accordance with the closing agreement. These computations resulted in an overpayment of \$██████████ for ██████████. A second set of computations were prepared leaving the TEFRA partnerships items as reported on the return. These computations resulted in a deficiency for ██████████ of approximately \$██████████.

Discussion

In your memorandum requesting this tax litigation advice you raise several questions on how the procedures for computing deficiencies will apply after Munro v. Commissioner, 92 T.C. 71 (1989). Prior to Munro, it had been the practice of the Service to compute deficiencies for statutory notice purposes by assuming that all items relating to partnerships that are subject to a TEFRA proceeding were correctly reported. An exception to this rule existed for situations such as in Munro where no deficiency would have resulted using this approach because of the magnitude of the TEFRA adjustments. In these cases, the TEFRA adjustments were included for computational purposes only.

In Munro, the Tax Court upheld the validity of a statutory notice of deficiency that disallowed TEFRA partnership losses instead of eliminating them from the return before doing the statutory notice computation. The court ruled that it was impermissible for the Service to disallow TEFRA partnership

losses in the statutory notice, even if this was done solely for computational purposes and was not intended to be a substitute for issuing a notice of final partnership administrative adjustment (FPAA) as required by section 6225. More importantly, the court held that TEFRA partnership items (whether income, loss, deduction or credits) included on a taxpayer's return should be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items.

Since a literal application of Munro would require the deficiency to be computed without taking any TEFRA partnership items into account, this office recommended to the Examination and Appeals Divisions that they implement new procedures for computing deficiencies whenever non-TEFRA adjustments are to be made to a taxpayer's return that also contains TEFRA items. In those cases, it was determined that for purposes of computing a deficiency in compliance with Munro, all TEFRA items that had been reported on the taxpayer's return were to be removed, except those TEFRA items that had been finally determined by reason of a no change, a settlement, or a completed TEFRA proceeding.

Soon after these new procedures were worked out, Examination expressed its refusal to comply with Munro because of the administrative burden created by the new procedures. Furthermore, while we believe that the Tax Court's opinion is technically correct to the extent that the deficiency procedures and the TEFRA partnership procedures were intended to be separate, the solution proposed by the Tax Court is unworkable as a practical matter. In the typical case, computing the tax liability without reference to partnership items will have the same effect as though partnership items were disallowed. If the partnership items were losses, the effect will be a greatly increased deficiency for the nonpartnership items. If, when the partnership proceeding is completed, the partner is ultimately allowed any part of the losses, he will receive part of the increased deficiency back in the form of an overpayment. However, in the interim, he will have been subject to assessment and collection of a deficiency inflated by items still in dispute in the partnership proceeding. In essence, implementation of Munro in the typical case means loss of a prepayment forum for the partnership proceeding. As a policy matter, we view this result as being an inappropriate and unintended consequence of implementing Munro. Accordingly, a legislative solution is being sought.

In the interim, it is this office's position that for purposes of computing a deficiency for purposes of a statutory notice when non-TEFRA adjustments are to be made to a taxpayer's return that contains TEFRA items, the Munro procedures are to be

applied. 1/ However, as to those cases where the statutory notice of deficiency is not computed in accordance with Munro and the deficiency case is settled prior to the completion of the TEFRA proceeding, the TEFRA items are to be treated as if they were correctly reported on the taxpayer's return for purposes of recomputing the deficiency on the decision document. Any change to the deficiency liability caused by resolution of the TEFRA proceeding must be resolved by a stipulation between the parties, incorporated in the decision document, stating that any change to the deficiency liability caused by resolution of the TEFRA proceeding can be assessed at the conclusion of the TEFRA proceeding as a computational adjustment. See Notice N(35)(24)60-1. (Copy attached).

In the present case, because the petitioners have entered into a closing agreement settling their TEFRA items prior to the completion of the deficiency case, the procedures in Notice N(35)(24)60-1 would not apply. 2/ However, the execution of the closing agreement for the TEFRA items has the affect of treating those items as being finally determined.

In preparing the settlement computations in accordance with the Munro procedures, since the TEFRA items have been finally determined, they would not be removed from the computation. Instead, they would be included in the computation as they were finally determined. Thus, the decision document in this case would reflect an overpayment of \$ [REDACTED], as illustrated by the following computation:

Taxable income per return	\$ [REDACTED] <u>3/</u>
TEFRA Item Adjustments as	
Finally Determined	[REDACTED]
Modified Taxable Income	[REDACTED]
Non-TEFRA Adjustments to Income	[REDACTED]

1/ We recognize that the Office of the Assistant Commissioner (Examination) has decided not to follow our advice due to the administrative difficulty of doing so.

2/ We note that your memorandum states that the closing agreement has yet to be executed by the Service. We recommend that it be executed prior to executing the decision document in this case for the reasons to be discussed below.

3/ An adjustment to taxable income should be made to reflect the assessments based on the taxpayers' amended return. However, no adjustment to taxable income should be made to reflect the result of a tentative net operating loss carryback allowance. We recommend that a stipulation be included in the decision document stating that the taxable income does not take into account the tentative carryback.

Modified Taxable Income as Adjusted
 Tax on Modified Taxable Income
 Tax Liability on Modified Taxable
 Income as Adjusted
 Tax Previously Assessed and Paid
 Overpayment

\$

Because the petitioners' TEFRA items are treated as being finally determined by the prior execution of the closing agreement, the Tax Court will have jurisdiction to grant an overpayment in the deficiency case under I.R.C. § 6512(b). Thus, the petitioners can be assured that they will receive their \$ overpayment. 4/

If the facts of this case had been such that the TEFRA proceeding had not been completed prior to the deficiency case, then under our position, the decision document would have reflected an increased deficiency due to the inclusion in the recomputation of the TEFRA income as if it were correctly reported. The decision document would have to include a stipulation stating that any change to the deficiency liability caused by the resolution of the TEFRA proceeding would be made at the completion of the TEFRA proceeding by a computational adjustment, as Notice N(35)(24)60-1 provides.

Your memorandum also raises concern over the coordination problems between the Offices of Appeals and Examination when the TEFRA case is settled prior to the non-TEFRA case. We have discussed this problem with National Offices of Appeals and Examination, and they have informed us that they have proposed a coordination system to resolve these problems.

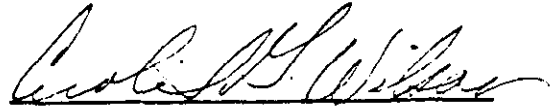
A proposed draft of the TEFRA Appeals Handbook provides for a six step coordination procedure that appeals officers are to follow when the TEFRA case is settled prior to the non-TEFRA case. Presently, the Examination AIMS Manual only provides revenue officers with coordination procedures to follow when the non-TEFRA issues are settled prior to the TEFRA issues. However, we have been advised by Examination that they are revising their manual to make coordination mandatory when the TEFRA case is completed prior to the non-TEFRA case by providing that revenue officers prepare and send closing packages to the appeals office having control over the non-TEFRA case.

4/ We note that if the parties are in agreement as to the adjustments but cannot agree on the computations, unagreed Rule 155 procedures may be followed.

Should you have any further questions regarding this matter, please contact Jeff Rosenberg at (FTS) 566-3233.

MARLENE GROSS

By:



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